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TAGS: ECON EINV EFIN PGOV TU
SUBJECT: MARKET ANALYSTS OPTIMISTIC FOR THE SHORT-TERM, BUT SEE RISKS RE-EMERGING IN THE FALL

REF: A. ANKARA 4480
¶B. ANKARA 4551

¶1. Sensitive but Unclassified. Not for internet distribution.

¶2. (SBU) Summary: Istanbul market analysts have welcomed recent progress in Turkey-IMF relations and indications that the oft-delayed fifth review can be wrapped up by early to mid-August. As a result they are "optimistic" for the short term, seeing no clouds on the immediate horizon and believing investors can realize 8-9 percent returns over the next two months in dollar terms on Turkish bonds. Beyond this market play, however, they warn us that overall sentiment is not good, and they continue to see significant "implementation risks" for the fall, particularly as the tougher requirements of the sixth review come into play. The wild card in the picture remains the strong Turkish lira, which analysts continue to have difficulty explaining. Criticism of the Central Bank is growing, however, with few buying its argument that its interventions have been aimed solely at curbing volatility in the market. End Summary.

¶3. (SBU) Guarded Optimism: Recent soundings with analysts at Istanbul brokerages and banks show that optimism is increasing, at least for the immediate future. Bender analysts Emin Ozturk and Murat Gulkan, who earlier this year highlighted to us the frequent failure of the summer "carry trade" (purchasing government bonds to earn high rates, while counting on the exchange rate to stay fairly stable) to be as profitable as markets expected, told us this week that, this year at least, the bet appears to have paid off. Baturalp Candemir at HC Istanbul shares that view, arguing that with no major clouds on the horizon following progress registered during the recent IMF mission, investors should be able to realize 8-9 percent in dollar terms over the next two months. In a world where investors are scraping to realize 2 percent elsewhere annually, the opportunity makes Turkey appear very attractive, despite its currently overvalued exchange rate. Ozturk and Gulkan noted that while July and August are typically "dead" periods at their firm, this year the phone has been ringing off the hook with inquiries about opportunities in Turkey.

¶4. (SBU) Implementation Risk: While progress registered during the recently concluded IMF mission removed the last clouds from the short-term horizon of these analysts, Candemir did express some scepticism about whether the additional financial measures the IMF and government have agreed on will prove sufficient to achieve the program's 6.5 percent primary surplus target. The IMF's blessing, he said, however, would be enough to satisfy the markets. For the longer term he is less sanguine, seeing significant implementation risk, particularly if his expectation is met that these measures will be insufficient. Given the political difficulties inherent in laying off more employees at state-owned enterprises, he predicted that the sixth review would drag on until the end of the year. The real crunch, most analysts here suggest, will begin in September, as investors start to worry about next year's debt burden, and intensify in the second half of October, when government-IMF discussion of the 2004 budget begins in earnest. Ozturk and Gulkan note that while the AK government has "moved up a learning curve," the ingredient that is currently missing is word about their plans for next year: Will it seek to scale back the primary surplus, or accept that it needs to be maintained at a high level? Key to market stability at that point, Candemir argued, will be evidence that promised U.S. assistance is on track, and continued reform implementation.

¶5. (SBU) Exchange rate dynamics: The key wild card in the current economic picture is the strong Turkish lira, which has gone from strength to strength, shrugging off the Central Bank's July 18 intervention and not losing ground to the dollar, even as it has strengthened against other currencies. Observers remain divided on the reasons for the lira's strength. Some, like Candemir, see "under the mattress" money reentering the system to benefit from high interest rates and to participate in various recent economic amnesties. Others, like former Yapi Kredi Chairman Burhan Karacam, see other issues at work, attributing the lira's rise to a timing gap between payments for imports and exports. Karacam suggests that a large supply of dollars accumulated in the run-up to the Iraq war, as exporters held off exchanging their earnings in expectation that the lira would weaken. When the war ended quickly, those dollars flooded into the market, driving its rate down. In contrast, however, while Turkey's current account deficit would suggest there should be strong demand for dollars, in fact importers utilize delayed payment terms and invest the money in short-term government bonds to benefit from high real rates. Karacam suggests that many of these payments come due in mid-October, at which point he predicts that there could well be a "squeeze" in the currency market, and a sudden sharp drop in the lira. (Karacam noted that he recently made these points to Central Bank governor Serdengecti, who is looking into the issue.)

¶6. (SBU) Differences: Not all agree with this explanation, however. While most see merit in the first part of the story, in the flood of dollars that followed the war, they are less convinced that most importers are deferring their payments to the fall. (Our random sampling of importers confirms that such extended payment terms are not by any means general.) Ozturk and Gulkan suggest a combination of other factors can explain most recent developments: in addition to "under the mattress" money, some "hot money" has flowed into the market (perhaps 1.5 billion usd), while Turkish financial institutions (acting largely through subsidiaries, since under BDDK rules limit their ability to do so themselves) have opened short positions. Candemir noted that he had expected the lira to continue to appreciate to 1.35 million during August, due to an essential balance in currency inflows and outflows. The Central Bank's recent intervention, however, has changed the market's dynamics. Far from easing the market's volatility, he suggested, it has increased it. Ozturk was similarly critical, suggesting that the bank had "panicked" because of the failure of its recent interest rate cut to move the currency.

¶7. (SBU) Bank Credibility: Both Ozturk and Candemir warn that the key risk from the bank's recent intervention is to its credibility. While it continues to insist that it is acting only to prevent market "volatility," many observers have concluded that its true concern is the currency's value. With the government enjoying only limited credibility in the market, Candemir warned that if the bank similarly "loses credibility," it will leave the country without any credible voices on economic policy.

¶8. (SBU) Comment: Though the underlying dynamics of concern with the long-term plans of the AK government on economic policy have not changed, clearly recent progress on the 5th review and Turkey's traditional "summer optimism" have combined to give the government some much needed breathing space. That will not last forever, however. As Mehmet Besimoglu wrote in Radikal on July 21, because it's summer there is a "tendency to see the glass as being half full; if necessary measures are not taken before fall attention will shift to the empty half." Istanbul analysts worry, though, that such warnings may now have little resonance. Just as the government has little credibility with them, so they have little credibility with it, in that their warnings of dire consequences for the government's policy missteps have not been realized. End Comment.
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